21st Century Retirement

The Many Facets of Retirement Planning:

Stretching an IRA into Future Generations

Imagine that you could wave a magic wand and turn your new grandchild into a millionaire for a head start in life. Believe it or not, even a relatively modest amount tucked away using a “stretch” IRA strategy could, under certain market conditions, evolve into a rather substantial nest egg that your grandchild, or other beneficiary, may enjoy in years to come.

A Long-Term Strategy

The stretch IRA strategy is an Individual Retirement Account (IRA) in which earnings are allowed to grow tax deferred over a beneficiary’s lifetime. If you have an IRA that you do not need for retirement income, you can opt to restrict your withdrawals to the minimum annual distribution required by the Internal Revenue Service (IRS) starting at age 70½. Required minimum distributions are based on your life expectancy and the amount of funds in your account.

If you decide you want to stretch your IRA into future generations, you can establish a trust that allows for the distribution of IRA assets to primary, and possibly secondary, beneficiaries. Upon your death, your beneficiary will be permitted to take distributions over time, based on his or her age and life expectancy. This not only gives the investments in the account a chance to grow and compound, but it also means that income taxes owed on the IRA can be paid over an extended period of time.

If you choose a very young beneficiary, such as a grandchild, the funds in the IRA may compound substantially over the course of a lifetime. Provided the beneficiary does not access funds in the account along the way, due to a disability or other hardship, a considerable sum could amass by the time he or she reaches retirement.

Risks Involved

Before you integrate the stretch IRA strategy into your estate plan, it is important to note that this approach does carry some risk. If IRA assets decline in value, or if inflation erodes the value of your savings, the substantial returns for your heirs may not materialize.

Should you live a very long life, it is also possible that the funds in your IRA may not grow because you must continue to take required distributions. If, for example, longevity is on your side and you live to

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age 95, the amount you leave to a grandchild may be less than if you had passed on a decade earlier.

Keep in mind, too, that a stretch IRA strategy works best when only the required minimum distributions are withdrawn. If your beneficiary were to withdraw additional funds to buy a car or pay the rent, the account could be quickly depleted.

Finally, it is important to consider the tax implications of including a stretch IRA strategy in your inheritable estate. Under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (2010 Tax Relief Act), the Federal estate tax and generation-skipping transfer (GST) tax, which had been repealed in 2010, has been reinstated, with an exemption amount of $11.18 million and a top tax rate of 40% through 2018.

Despite the inherent risks, a stretch IRA strategy can be a tax-efficient means for passing on savings to future generations. While there is no guarantee that inheriting a stretch IRA can turn your grandchild into a millionaire, it could help contribute toward making his or her retirement more comfortable.

Retirement Plan Assets and Multiple Taxation

Retirement planning generally focuses on accumulating funds to support your desired lifestyle after your departure from the workplace. At the same time, it is important to realize that, in all likelihood, your retirement savings may constitute a very large portion of your total assets. Upon your death, items such as your personal property and savings may ultimately be subject to varying degrees of estate taxation. Like all other assets, your retirement savings are generally included. However, retirement plan assets are also subject to *income* taxes in addition to *estate* taxes.

Should You Be Concerned?

Historically, high net worth individuals have been the most concerned with estate taxation. If you have more than the applicable exclusion amount of $11.18 million in 2018 (adjusted annually for inflation), you may want to review the Federal estate tax implications with your professional advisors. With advance planning, you may be able to minimize your estate tax liabilities. Since your retirement plan assets are part of your estate, they may also be subject to estate taxation. In general, estate taxes are based on the full, *pre-income tax* value of the plan assets. In addition, income taxes will also be due on *pre-estate tax* values.

A distribution of the qualified plan or Individual Retirement Account (IRA) balance at an employee's or IRA owner's death can be income in respect of a decedent (IRD). Generally, IRD is included in the gross income of the recipient beneficiary, although there is a deduction for estate and generation-skipping transfer

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(GST) taxes paid on the income. If the income is distributed over a number of years, only a proportional amount of the deduction is allowable each year.

Substantial retirement plan assets, especially those for which no advance planning has been made, may ultimately be subject to income and estate taxes at a combined marginal rate that could potentially approach, or even exceed, 70%. That translates into nearly three out of every four dollars of your retirement savings going toward paying taxes, rather than funding your retirement or passing to your heirs.

Are There Any Alternatives?

Implementing a tax strategy geared toward passing retirement plan assets *in full* to heirs can be challenging, especially if you plan to depend on these assets to meet your retirement income needs. However, those who are fortunate enough not to need the bulk of this income may consider taking all, or part, of the balance in a lump sum. Amounts not distributed may be directly transferred from the plan to an IRA. Even though income taxes are due in the tax year of the withdrawal, the after-tax proceeds may be slowly gifted directly to heirs free from additional taxation.

This gifting program can involve either *direct* transfers or transfers to an irrevocable trust established to benefit the heirs (gifts of $15,000 per individual or $30,000 for married couples in 2018, indexed annually for inflation, can be made annually without incurring a gift tax).

It Pays to Plan

Saving for retirement requires hard work, foresight, and diligence. Once you have built your retirement assets, the challenge becomes asset preservation. With the assistance of qualified legal, tax, and financial professionals to review all the legal and tax consequences of your planning decisions, you may be able to enjoy your retirement while simultaneously passing on a sizable nest egg to your loved ones.

Social Security, Main Source of Income

While most Americans are aware of the steps they should be taking to prepare for retirement, many are struggling to build adequate savings, and thus expect to rely heavily on Social Security after they stop working, a survey carried out by digital wealth manager Personal Capital has shown.

The survey of 2,008 U.S. adults aged 18 and older – including 1,630 pre-retirees – was conducted on March 1-7, 2018. When asked to identify their primary source of retirement income, 27% of the pre-retirees surveyed cited an employer-sponsored plan, but one-quarter cited Social Security, including 15% of millennial and 29% of Gen X respondents. The findings also indicated that 51% of all of the pre-retirees surveyed and 62% of the millennial respondents plan to retire at age 65 or younger, or at least a year shy of the age at which Americans born after 1943 are entitled to collect the full Social Security benefit.

Somewhat surprisingly, the survey results indicated that Gen Xers are almost as likely as millennials to lack adequate savings, despite having less time to save before reaching retirement age. Even though more than half of respondents of both generations (56% and 57%, respectively) said they expect they will need to save more than $1 million for retirement, 34% of the Gen Xers and 39% of the millennials surveyed admitted they have no retirement savings. In addition, the Gen Xer respondents were less likely than the millennial respondents to report that they max out their employer-sponsored plan contributions (18% vs. 22%).

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Social Security, Main Source of Income (cont.,)

Moreover, the survey showed that younger workers are less likely than older workers to place importance on getting financial advice on retirement planning: just 24% of Gen Xer and millennial respondents said they believe that consulting a skilled financial advisor is crucial to achieving a comfortable retirement, compared to 30% of the baby boomers surveyed.

The survey also uncovered significant gender differences in retirement planning patterns. For example, more of the female than the male pre-retiree respondents indicated that they understand that sticking to a comprehensive financial plan (62% vs. 47%, respectively) and leveraging a skilled financial advisor (28% and 24%, respectively) are critical to securing a comfortable retirement. The results also showed, however, that 40% of the female respondents, compared to 33% of the male respondents, admitted that they have no retirement savings; and that 71% of female respondents, compared to 56% of male respondents, acknowledged that they do not know their net worth.

The findings suggested that the gender gap in retirement savings may be partially attributable to women being less likely than men to have access to a range of retirement savings options, as 27% of the employed women surveyed, compared to 19% of their male counterparts, reported that they are not offered an employer-sponsored retirement plan. But the survey results also showed that when women have access to these benefits, they often fail to take full advantage of them: the female respondents were found to be less likely than their male counterparts to contribute to a retirement plan offered by their employer (58% vs. 67%) or to max out contributions to their employer-sponsored retirement plan (16% vs. 26%).

Easing into Retirement

To minimize disruptions in the natural progression of workforce turnover and to foster sound workforce planning, employers should help employees stay on track for retirement by quantifying their levels of retirement readiness, a study released by Sibson Consulting has recommended.

The study, "Quantifying Retirement Readiness: How to Determine if Your Employees Are on a Smooth Path to Retirement," was published in the January 2018 issue of the firm's newsletter. According to the analysis, many employers have no idea how financially prepared their employees are for retirement. For example, the study's authors pointed out, companies may be unaware that have a quite a few later-career employees who are nowhere near ready for retirement, or a number of mid-career employees who have plenty of savings to retire and are looking for an early exit.

The study's authors therefore recommended that employers use a comprehensive strategy to understand how retirement readinessdefined as the ability to retire with sufficient income to maintain the individual's current standard of living throughout retirementaffects their business. Specifically, they suggested that employers identify which employees appear to be on track for a timely retirement and which do not, and take steps to help employees financially prepare for retirement.

According to the study, the most direct metric for retirement readiness is the replacement ratio, which defines the required income for retirement as a percent of income just before retirement. Setting a ratio of 80% as the benchmark, the authors observed that part of the replacement income will come from Social Security and other retirement vehicles, while the remainder will come

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from savings and other assets. However, they cited research showing that the contributions of these sources will vary by generation: for example, whereas the average retiree currently aged 69-89 receives an estimated 22% of his or her income from an employer-sponsored pension, a worker currently aged 25-49 can expect to receive only 12% of his or her retirement income from an employer-sponsored pension.

The study's authors further emphasized that when employees start accumulating retirement wealth and when they begin drawing from this accumulation are key to determining an appropriate savings rate. They warned that since most replacement ratios use a retirement age of 65, employees who plan to retire before that age will need to accumulate more savings to attain the same replacement ratio for the additional years in retirement. While acknowledging that there is no single "right" answer for a wealth-accumulation target, researchers estimated that a target of 10 times the individual's pay is reasonable for a worker retiring at age 65.

Finally, researchers advised employers to provide employees with a qualitative assessment of their progress so they can see if they are falling short of their desired replacement ratio and wealth-accumulation target. For example, employers can use retirement-readiness letter grades that score an employee's current standing based on his or her age plus the expectation that he or she will reach an appropriate level of retirement readiness.

"Once this information is clear, the next step is to develop and implement strategies to help employees retire when they want to," the study's authors concluded, adding that these strategies may include using plan design analysis/changes, educational materials, or communications campaigns to affect behavioral changes

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